

Section 17951-6 is adopted to read:

§17951-6. Income from a Covenant Not to Compete.

(a) General. Income from a covenant not to compete executed in connection with the sale of a business conducted entirely within California or within and without California has a source in California to the extent the income is assigned to this state under this regulation and to the extent that the taxation of the assigned income is not prohibited by federal statutes or by the federal or California Constitution.

(1) Income from a covenant not to compete is assigned under the rules of this regulation by first identifying the legally enforceable area within which the promisor forfeits the right to act. The income is then assigned to locations within the legally enforceable area according to a formula consisting of the average equally weighted property, payroll and sales factors of the business which was sold.

(2) The factors to be used are those of the business which was sold for the income year, in the case of corporations subject to the franchise tax, or the taxable year, in the case of other businesses, in which the sale of the business occurs.

(3) Except as otherwise provided, the denominator of the factors consists of property, payroll and sales assigned to the legally enforceable area, in accordance with the provisions of UDITPA, sections 25120 through 25137, inclusive, Revenue and Taxation Code, and the regulations thereunder. The numerator of the factors consists of property, payroll and sales included in the denominator which are assigned to California in accordance with the provisions of UDITPA, sections 25120 through 25137, inclusive, Revenue and Taxation Code, and the regulations thereunder. For purposes of computing the numerator and the denominator of the sales factor pursuant to Section 25135, Revenue and Taxation Code, all sales of tangible personal property are assigned to the state of the purchaser where the property is delivered or shipped, and the provisions of Section 25135(b), Revenue and Taxation Code (relating to throwback sales), shall not apply.

(4) A covenant not to compete includes any arrangement to refrain from engaging in an activity, directly or indirectly, similar to the business activity carried on by the business which was sold.

(5) The sale of a business includes all the following:

(A) The sale or disposition of the goodwill of a sole proprietorship, partnership, limited liability company, S corporation or C corporation.

(B) The sale or disposition of substantially all the assets, together with the goodwill, of a sole proprietorship, partnership, limited liability company, S corporation or C corporation.

(C) The sale or disposition of substantially all of an individual's interest in a sole proprietorship, partnership, limited liability company, S corporation or C corporation, including, but not limited to the following:

1. The sale or disposition by a shareholder of substantially all of its shares in a corporation.
2. The sale or disposition by a partner of substantially its entire interest in a partnership.

(6) If the assignment of income provisions in this regulation do not fairly reflect both the nature of prohibited activities expressed or reasonably implied from the covenant not to compete and the locations where the value of the business sold is concentrated, or the use of the factors for the year of the business in which the sale occurs does not accurately represent the location of recent historical business activities of the business sold, such that there is a gross distortion of income assigned to California, the Franchise Tax Board may require, or the promisor may petition the Franchise Tax Board for:

(A) The use of factors of the business which was sold for another year or combination of years.

(B) The employment of another method of assigning income within the legally enforceable area, provided the use of another year or years or another method produces a fair and equitable result.